

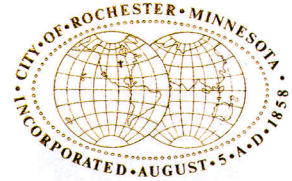
CITY OF ROCHESTER, MINNESOTA
INTRODUCTORY SECTION
DECEMBER 31, 2002

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ROCHESTER

Minnesota



June 12, 2003

FINANCE DEPARTMENT
201 4th Street SE, Room 204
Rochester, MN 55904-3779
(507) 285-8088
FAX #(507) 529-4587

To the Honorable Mayor, Members of the Common Council, and the Citizens of the City of Rochester:

Minnesota statutes require all cities to issue an annual report on its financial position and activity prepared in accordance with generally accepted accounting principles (GAAP), and audited in accordance with generally accepted auditing standards by a firm of licensed certified public accountants or the Office of the State Auditor. Pursuant to that requirement, we hereby issue the comprehensive annual financial report of the City of Rochester for the fiscal year ended December 31, 2002.

This report consists of management's representations concerning the finances of the City of Rochester. Consequently, management assumes full responsibility for the completeness and reliability of all the information presented in this report. To provide a reasonable basis for making these representations, management of the City of Rochester has established a comprehensive internal control framework that is designed both to protect the City's assets from loss, theft, or misuse and to compile sufficient reliable information for the preparation of the City of Rochester's financial statements in conformity with GAAP. Because the cost of internal controls should not outweigh their benefits, the City of Rochester's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

The City of Rochester's financial statements have been audited by Smith, Schafer and Associates, Ltd., a firm of licensed certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of the City of Rochester for the fiscal year ended December 31, 2002, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditor concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the City of Rochester's financial statements for the fiscal year ended December 31, 2002, are fairly presented in conformity with GAAP. The independent auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the City of Rochester was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the City's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are available in the City of Rochester's separately issued Single Audit Report.

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GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The City of Rochester's MD&A can be found immediately following the report of the independent auditors.

PROFILE OF THE GOVERNMENT

The City of Rochester, incorporated on August 5, 1858, is located in the southeastern part of the State of Minnesota, which is considered to be one of the top growth areas in the state, and one of the top growth areas in the country. The City currently has a land area of nearly 47 square miles and serves a population of 91,264. The City of Rochester is empowered to levy a property tax on both real and personal properties located within its boundaries. It also is empowered by state statute to extend its corporate limits by annexation, which is done periodically when deemed appropriate by the governing council.

The City of Rochester is governed under a charter adopted August 22, 1904. Policy-making and legislative authority are vested in a governing council consisting of the mayor, the council president and six council members. The governing council is responsible, among other things, for passing ordinances, adopting the budget, appointing committees, and hiring both the City's administrator and attorney. The City's administrator is responsible for carrying out the policies and ordinances of the governing council, for overseeing the day-to-day operations of the City, and for appointing the heads of the various departments. The council is elected on a non-partisan basis. Council members, the president and mayor all serve four-year staggered terms, with four of these positions elected every two years. Six of the council members are elected by ward. The mayor and council president are elected at large.

The City of Rochester provides a full range of services including police and fire protection; construction and maintenance of streets and infrastructure; recreational facilities, library and cultural events; water, sewer, electric, public parking, mass transit and airport services.

The annual budget serves as the foundation for the City of Rochester's financial planning and control. All departments and agencies of the City of Rochester submit requests for appropriation to the city administrator in August of each year. The city administrator uses these requests as the starting point for developing a proposed budget. The city administrator then provides this proposed budget to the council for review prior to November 15th. Work sessions are then held with the council covering each department budget. The council is required to hold public hearings on the proposed budget and to adopt a final budget by no later than December 31, the close of the City of Rochester's fiscal year. The appropriated budget is prepared by fund, function (e.g., public safety), and department (e.g., police). Department heads may make transfers of appropriations within a department. Transfers of appropriations between funds, however, require the special approval of the city council. Budget-to-actual comparisons are provided in this report for each individual governmental fund for which an appropriated annual budget has been adopted. For the general fund, this comparison is presented on page 28 as part of the basic financial statements for the governmental funds. For governmental funds, other than the general fund, with appropriated annual budgets, this comparison is presented in the governmental fund subsection of this report, which starts on page 80.

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FACTORS AFFECTING FINANCIAL CONDITION

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the City of Rochester operates.

Local economy. The third largest City in Minnesota, Rochester is located 78 miles southeast of Minneapolis and St. Paul. Rochester's strong economy is built around world-renowned health care, cutting-edge technology, agriculture and agribusiness. As home to the Mayo Clinic and IBM Rochester, the City has developed into an economic growth center and the cultural hub of southeastern Minnesota. Its many recreational and cultural activities draw people from southeastern Minnesota and northern Iowa. Add these benefits to a low crime rate and an exceptional school system and it is easy to see why *Money* magazine continues to rank Rochester in the top places to live.

Continued strength in the health care sector and the considerable stability in local technology employers, despite the retrenchment nationally in that sector, combine to provide continued employment growth in Rochester. The number of jobs here has been growing faster than the national average and the local unemployment rate has lingered below national and statewide marks. Ending the first quarter of 2003 up slightly to 4.0 percent, Rochester's unemployment rate compares favorably to the state and US averages of 4.9 and 6.2 percent. The region (which includes Rochester and the surrounding unincorporated area within the same county) has an employed labor force of approximately 86,200. While the City has followed the national trend in its loss of manufacturing jobs, one local economist feels this "bottomed out about a year and a half ago." Jobs in health services and education were the fastest growing among Rochester area industries in 2002, due largely to continued expansion of Mayo Clinic and new business start-ups. During the first quarter of 2003, for example, new business filings were up 150 percent over a year ago with 215 new businesses filed in this quarter alone. With first quarter commercial building permits up 11.5 percent over last year's number and totaling nearly \$71 million, Rochester's economy continues on a growth track.

Long-term financial planning. The Rochester council is directing City staff on numerous projects that will affect the growth of the City. A partial list includes:

- Highway 52 reconstruction. Billed as the largest single highway project in Minnesota's history, the \$113 million expansion and reconstruction of the major corridor through Rochester will employ hundreds of workers over the next four years and spawn development and redevelopment along the new frontage roads and bridge intersections.
- Water Quality Project. The \$22 million in sales tax monies allocated toward extending sanitary sewer and water lines to parcels adjacent to the City that had failing septic systems is continuing through this year and the next. In addition to the additional tax base provided by annexation of these developed properties, the project is providing for the development of many in-fill areas that were previously not able to be developed without this infrastructure.
- Highway 63 South Interchange. The council has directed staff to work with the State of Minnesota in the development of interchanges at the 48th Street and possibly 40th Street intersections of Highway 63 South. This will provide needed access infrastructure to allow planned large retail developments in the open lands adjacent to these intersections.

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Long-term financial planning (continued).

- Cascade Lake Development. The city has purchased some properties, provided for the relocation of power lines, obtained easements and accepted development plans for the gravel mining and eventual development of what will become the largest lake in the area. With adjacent public parkland and a public bike trail surrounding the lake this project is shaping up to become a significant attraction for both new residential development, and for all the citizens of Rochester to enjoy.
- Storm Water Utility. The new regulations on water quality have moved staff to propose the creation of a storm water utility for Rochester that will collect monies from property owners based upon impervious surface of parcels and use the monies to fund regional storm water pond construction and other runoff water quality improvement measures.
- Electric System Improvements. The Rochester Public Utility (RPU) issued \$11.275 million in revenue bonds during 2002 to fund planned improvements in the electric system infrastructure to provide for the continued expansion in RPU's service area.
- Waste Water Treatment Plant Expansion. City staff is exploring options to meet the ever-growing capacity demands at the City's wastewater treatment plant. Current estimates suggest an expansion costing approximately \$32 million to be constructed over the next four years.

Cash management policies and practices. Cash temporarily idle during the year was invested in short-term government money market accounts, commercial paper, obligations of the U.S. Treasury and its agencies, and municipal bonds. The maturities of the investments range from 30 days to 22 years with an average maturity of 2.2 years. Investment income includes appreciation in the fair value of investments. Increases in fair value during the current year, however, do not necessarily represent trends that will continue; nor is it always possible to realize such amounts, especially in the case of temporary changes in the fair value of investments that the government intends to hold to maturity.

Risk management. The City maintains a self-insurance program for employee group health coverage and workers' compensation and a high deductible policy on property and casualty coverage. The group health program is limited to losses of \$225,000 per claim with a variable annual aggregate, and the 2002 workers' compensation exposure is limited to \$700,000 per occurrence, both through the use of stop-loss policies. The City's general and auto liability policies retain a \$100,000 aggregate deductible exposure with a \$1,000,000 statutory limit of coverage. The City recognizes a liability on individual claims when a claim is probable and the amount can be reasonably estimated. In addition the City recognizes an estimated liability on claims that have been incurred but not reported. An indication of the effectiveness of the workers' compensation program is that the premium allocation for workers' compensation for 2002 is estimated to be a factor of 0.10 of the Workers' Compensation Reinsurance Association adjusted pure premium exposure base rate. Health coverage premiums were increased 15% in January of 2001 and 15% for 2002 in response to increased loss experience in this area. Dental premiums were not increased in 2002. Premiums still remain below average market for comparable coverage. Additional information on the City's risk management activity can be found in Note 4:A of the notes to the financial statements.

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Pension. Substantially all employees of the City of Rochester are covered by a statewide defined benefit pension plan administered by the Public Employees Retirement Association of Minnesota (PERA). Employees participated in one of the following plans during 2002:

Public Employees Retirement Fund (PERF), a cost-sharing multiple-employer plan
Public Employees Police and Fire Fund (PEPFF), a cost-sharing multiple-employer plan

PERF members belong to either the Coordinated Plan or the Basic Plan. Coordinated members are covered by Social Security and Basic members are not. All new members must participate in the Coordinated Plan. All police officers, fire fighters and peace officers qualifying for membership by statute are covered by the PEPFF. Additional information on the City's pension benefits can be found in Note 4:E. of the notes to the financial statements.

AWARDS AND ACKNOWLEDGEMENTS

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Rochester, Minnesota for its comprehensive annual financial report for the fiscal year ended December 31, 2001. This was the thirty fourth consecutive year that the City has received this prestigious award. In order to be awarded a Certificate of Achievement, the government must publish an easily readable and efficiently organized comprehensive annual financial report. This report satisfied both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement Program's requirements, and we are submitting it to GFOA to determine its eligibility for another certificate.

The preparation of this report could not be accomplished without the professional, efficient services of many dedicated people. We first express our appreciation to all members of the Finance department who assisted and contributed in preparing the report. We also thank the staff of Smith, Schafer and Associates, Ltd. for their assistance and review of the document. And finally, we acknowledge the Mayor and the members of the Common Council for their interest and support in planning and conducting the financial operations of the City in a responsible and progressive manner.

Respectfully submitted,



Dale R. Martinson
Director of Finance



Stevan E. Kvenvold
City Administrator

Certificate of Achievement for Excellence in Financial Reporting

Presented to

City of Rochester,
Minnesota

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
December 31, 2001

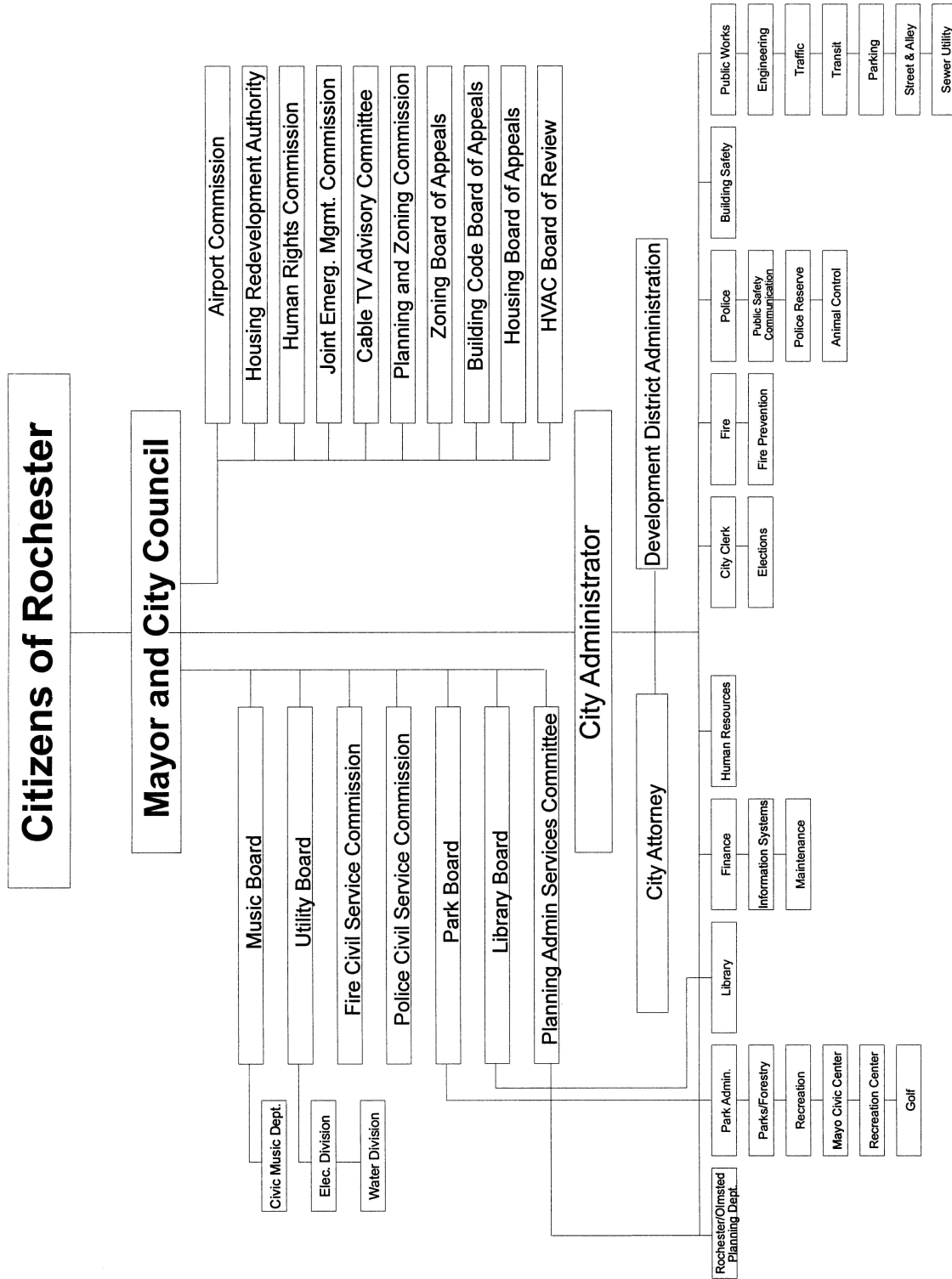
A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director

CITY OF ROCHESTER, MINNESOTA ORGANIZATIONAL CHART



**CITY OF ROCHESTER, MINNESOTA
LIST OF ELECTED AND APPOINTED OFFICIALS**

MAYOR - COUNCIL

	Initial Term <u>Commenced</u>	Current Term Expires <u>December 31</u>
Mayor, Charles J. Canfield	1996	2002
Council President, John W. Hunziker	1994	2004
Councilmember First Ward, Dennis L. Hanson	1999	2006
Councilmember Second Ward, Marcia Marcoux	1996	2004
Councilmember Third Ward, Jean S. McConnell	1987	2002
Councilmember Fourth Ward, Walter S. Stobaugh	1994	2004
Councilmember Fifth Ward, Mack R. Evans	1993	2002
Councilmember Sixth Ward, David H. Senjem	1992	2004

CITY ADMINISTRATOR

Stevan E. Kvenvold

DIRECTOR OF FINANCE – TREASURER

Dale R. Martinson

OTHER CITY OFFICIALS

City Attorney, Terry L. Adkins
City Clerk, Judy Kay Scherr
Director of Public Works, Richard W. Freese
Director of Building Safety, Ronald D. Boose
Chief of Police, Roger L. Peterson
Fire Chief, David A. Kapler
Director of Human Resources, Linda F. Gilsrud
Director Library Services, Audrey Betcher
Superintendent of Parks and Recreation, Roy Sutherland
General Manager - Music, Steven J. Schmidt
General Manager - Public Utilities, Larry J. Koshire
Superintendent of Water Reclamation Plant, Lyle J. Zimmerman